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"REGULATORY RISK IN 1991"

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REGULATORY RISK IN 1991

If you ask a variety of different people what comes to mind when you mention the term "regulatory risk," you would probably get quite different answers from a commercial banker, a Congressman, a business executive, or, indeed, a central banker. As a member of the regulatory community, I feel that the most important risk in the coming months lies in the possibility that bank regulation may be fundamentally reformed. First, there is the risk that reform may not happen, and second, the risk that if it does happen it may not be done well.

For years increasingly urgent calls have been heard from various points across the land for reform of the legal structure governing this country's commercial banking industry, and its relationship to other financial services providers. It would seem that in recent months a broad basic consensus has emerged, especially and most importantly in the Congress, that the time has come to act. The upcoming Congress is slated to take up the task.

While this basic consensus to act--assuming it exists--is obviously a vital first step, that is as far as it goes. There is enormous disagreement as to what a reform package should include, and the formulation and enactment of a responsible and enduring new body of

banking law will be dauntingly difficult. It may be useful to those involved in trying to bring about reform to first have an overall view of the complexities that will need to be worked through before a satisfactory product can be assembled. It is from these complexities that the risks arise.

Do you remember the Rubik's Cube puzzle that was popular a few years ago? To put all the pieces of the cube into a desired configuration, each of the many separate parts had to simultaneously fall into place, and moving one to put it in order tended to upset the order of the others. Everything depended on everything else. Many of us gave up. Banking law reform is the same type of puzzle on an economy-wide, real-life scale and its solution is far too important to accept any less than success. There are three distinctly different groups of considerations, each with its own subsets of issues that must be reconciled in order to arrive at a sensible package. Virtually all of these groups and their subsets are interactive one with the other, and while some are complementary, many are in conflict in varying degrees.

First of all, it is necessary to identify those industry components that are candidates for reform.

- o Subset number one in this category involves the components of the so-called Federal safety-net. Deposit insurance, which has sparked the lion's share

of debate so far, falls into this category. But there are also important issues surrounding operation of the Federal Reserve's lender-of-last-resort function, the "discount window" in industry jargon, and access to the Fed's payment system.

- o A second subset involves appropriate lines of business for commercial banks -- "powers" is the industry shorthand here -- and this is a very hot potato as we shall see in a moment.
- o A third issue, philosophically straight-forward but fraught with endless nuances in its details, is settling upon what should be the basic legal structure of banking organizations. This one may involve more complex interaction with more items on the list than any other, as it impacts both of its sister subsets listed above, and virtually every one to follow.

Second, it is necessary to identify the involved elements of appropriate public policy and here again we find three subsets of issues.

- o The safety and soundness of depository institutions is paramount and many proposed reforms are circulating under this rubric.
- o Public convenience, however, must be served by an efficient industry that works smoothly and well for our society. Safety and soundness concerns, taken too far, raise the potential for ending up with a system

that is too rigid and unresponsive, thus rendering the whole exercise counterproductive.

- o Finally, in this group is the need for structuring the industry so that it is fully competitive domestically and internationally, and yet observes an appropriate level of competitive equity with other types of providers of financial services.

The third consideration is the strong and shifting crosscurrent of interests of various private groups. Lobbying the government on behalf of one's own point of view is as American as apple pie, and there is a marvelous array of eager players in this game. All have legitimate points to make, but divergence abounds. One chief executive, a man of great integrity, said to me with a twinkle in his eye, "All we want is a level playing field, defined as one that tilts two degrees in our direction." Here are a few areas of dispute.

- o How to accommodate equitably the conflicting interests of large and small banks? The industry itself speaks with different voices.
- o Should nationwide banking be allowed? There is a strong case for so doing, but many states are leery.
- o How should credit unions be treated? Many banks feel they have unfair competitive advantages, but the credit unions strongly disagree.

- o What are appropriate arrangements for U.S. banks operating overseas, and foreign banks operating here? A blizzard of economic, prudential and political issues here.
- o Should banking and insurance be allowed to commingle? If so, how? Many interests in both industries want to operate in the others' domain, while the powerful independent insurance agents are dead set against it.
- o How about commingling commercial banking and investment banking? If so, how?
- o Should the traditional separation of banking and the rest of commerce be retained or abolished? There is a lot of passion on both sides of this question, and very little hard evidence to offer clear guidance.
- o In fairness I must mention the possibility that various regulatory authorities may have less than complete convergence on matters such as supervisory scope.

Each issue is rich with nuances, alternatives, points of principle and points that are negotiable. Animal spirits, a favorite phrase of my economist colleagues, run high with the promise of competitive opportunity, and the perceived need to defend ground presently held.

The extent of interactivity and interdependency of these issues is dazzling. Like Rubik's cube, everything depends on everything else. Many examples could be

cited, but here are just two. What lines of business are to be permissible for banks (consideration group one) impacts heavily on what safety and soundness provisions are appropriate (consideration group two), and is of vital competitive concern to various private interests (consideration group three). Here's a second set. What legal organization structure is to be chosen (consideration group one) impacts heavily on public convenience and competitive concerns (consideration group two) and is of vital concern to a different set of private interests (consideration group three). And so on.

All of this brings me back to the two basic risks. My first concern arises from the conviction that reform is urgently needed. While the banking industry is far stronger and more resilient than the basket case its detractors depict, the long term best interests of the country cry out for change. Given all this complexity, the risk of legislative gridlock is significant indeed. The Congress could find itself unable to muster a majority vote for any specific proposal. To find ourselves unable to act would be cause for grave concern.

The second concern is that it is essential that any reform measures be comprehensive and internally consistent. Given all the above combined with the way our legislative process functions, it would be very easy

to wind up with a new regime that does not work well. If reform is addressed piecemeal, without a commitment to creating a coherent whole package, it seems unlikely to me that when it is all over and done the result will be satisfactory. The last occasion when it was politically possible to fundamentally restructure the banking laws was nearly sixty years ago. We need to get it right on the first try this time around, because the moment may not return soon.

In order to produce a result that will allow our financial services industry to be a vital and constructive force in our future economy, those involved in the upcoming debates must appreciate, tolerate, and seek ways to accommodate the array of legitimate considerations and interests involved. An urgent search for common ground must get going soon, led by the Congress, joined in good faith by all parties concerned, and fueled by the conviction that the vital interests of our nation's economy are at stake. No one will get a result perfectly to his liking, but everyone will be a winner if we can craft a sound and forward-looking reform.